



# MONTHLY ECONOMIC UPDATE August

Economy at a glance for August 2021

## SL in crisis mode

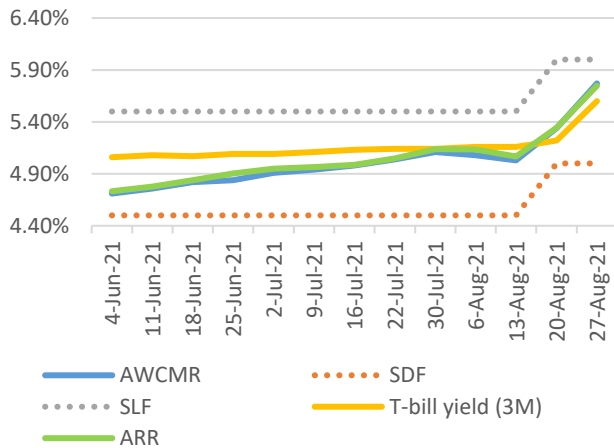
### Highlights

- The CBSL tightened its monetary policy stance on 19th August by 50 bps, becoming the first central bank in the region to do so. Accordingly, money market rates, bond yields, and prime lending rates rose.
- The lending through Standing Lending Facility was seen rising throughout the month causing overnight liquidity to turn negative briefly several times.
- The yields on ISBs maturing in 2022-23 shot up while others declined in the last week of the month as S&P downgraded the country's CCC+ sovereign rating outlook to Negative.
- The import bill exceeded USD 1.7 Bn, a 32% growth compared to the same month last year which led to a significant deterioration in the trade balance (-190%, Y/Y). Total remittances also declined by 35.4% (Y/Y) for the month resulting in worsening of current account balance.
- Sri Lanka received its SDR allocation equivalent to USD 787 Mn and a sum of USD 150 Mn under the swap arrangement with the Bangladesh Bank. In this setting, the overall reserve position strengthened to USD 3.5 Bn.
- Overall headline Inflation increased to 6% driven mainly by a surge in non-food inflation. Increase in non-food inflation is broad-based with notable rise in prices of Transport, Restaurants & Hotels, and Health subgroups.
- The stock market experienced a sharp uptick as the market closed with ASPI and S&P SL20 gaining over 10.8% and 10% respectively as investors turned bullish over speculation that GoSL was seeking support from the IMF for debt restructuring.
- PMI for Manufacturing and Services deteriorated compared to July due to the lockdown.

## Interest Rates

### Short-term rates

Figure 1: Treasury bill yield and money market rates



Notes: AWCMR- Average Weighted Call Money Rate, SDFR- Standing Deposit Facility Rate, SLFR- Standing Lending Facility Rate, T-bill yields are for the secondary market, ARR – simple average of daily repo rates  
Source: CBSL

The CBSL tightened its monetary policy stance on 19<sup>th</sup> August by 50 bps becoming the first central bank in the region to do so. The press release stated “These decisions were made with a view to addressing the imbalances on the external sector of the economy and to preempt the buildup of any excessive inflationary pressures over the medium term, amidst improved growth prospects” [1]. Accordingly, money market rates rose.

Following the rate hike, amid tighter liquidity, the volumes in the call and repo markets surged. The lending through Standing Lending Facility were seen rising throughout the month causing overnight liquidity to turn negative briefly several times. In addition, the CBSL absorbed some liquidity (roughly LKR 10 Bn a day) via overnight repos in the last week.

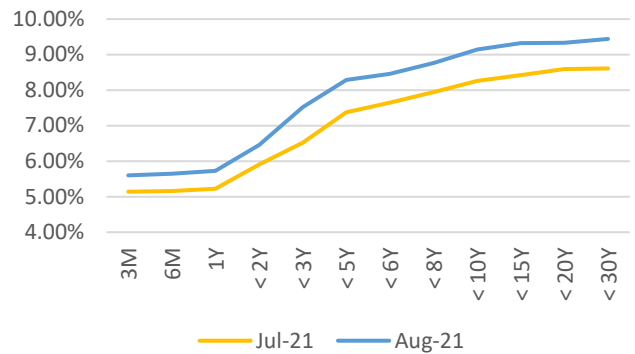
The CBSL added LKR 74 Bn to money circulation by purchasing T-bills from the primary auctions. Forex intervention by the CBSL caused USD 176 Mn net selling of forex in the market roughly

equivalent to LKR 36 Bn drain from the money supply.

The CBSL continued to relax the yield cap on 12M T-bill. However, the offer-to-acceptance ratio remained low for 6M and 12M treasuries. Secondary market T-bill yields rose ~50 bps while the market volume fell.

### Long-term rates

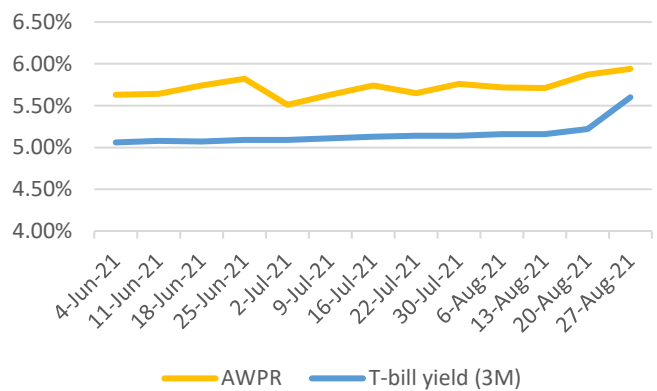
Figure 2: Yield curve of treasuries



Notes: Yields are based on the weekly average prevailed at the last week of the month, Shorter end – less than 2Y, mid/intermediate tenor – 2 to 10Y, longer tenor – above 10Y, Source: CBSL

The yield curve lifted up reflecting the policy rate hike by the CBSL. There was only one bond issue for the entire month of August which rendered a mediocre auction with extremely low offer-to-bid ratio.

Figure 3: AWPR<sup>1</sup> and 3M T-bill yield



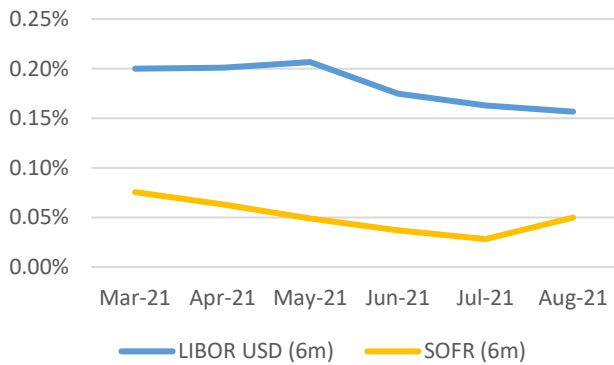
Note: T-bill yield for secondary market, Source: CBSL

<sup>1</sup> AWPR is calculated based on the submissions made by the commercial banks to the CBSL on the rates offered to customers who borrowed more than LKR 10 Mn for less than three months.  
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AWPR climbed 18 bps in August as the CBSL rate hike increased the price of money. It is likely the private credit may have continued to moderate during this time. In July, private credit grew 14.3% (Y/Y). This is an increment of about LKR 76.6 Bn increase from June.

**International rates**

Figure 4: Month open international lending rates



Notes: The SOFR Averages are compounded averages of the SOFR over rolling 180-calendar day periods. Source: New York Federal Reserve and global-rates.com

US Treasury yields surged as the senate passed a USD 1 Tn bipartisan infrastructure bill. In addition, higher producer and consumer inflation data and improving job numbers held the yields up. Talks of Fed tapering the QE programme also kept the yields high. Record performance of S&P 500 and Nasdaq Composite indexes attracted investors from treasuries to equities giving rise to yields. But fear of Delta-variant derailing economic recovery led to brief fall in yields of the long-end of the yield curve. In line with these developments SOFR rose while LIBOR USD continued to fall.

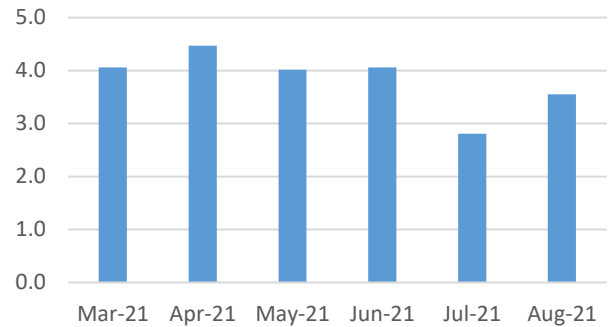
The yields on ISBs maturing in 2022-23 shot up while others declined in the last week of August as S&P downgraded the country's CCC+ sovereign rating outlook to Negative.

**External Sector**

Exports in July experienced a marginal increase to around USD 1.1 Bn with the most of it is comprised of Textiles & Garments (USD 454 Mn) and Tea (USD 115 Mn) sectors. The import bill exceeded USD 1.7 Bn, a 32% growth compared to the same month last year which led to a significant

deterioration in the trade balance (-190%, Y/Y). The main contribution to the trade deficit came from fuel (+USD 599.5 Mn, Y/Y), Machinery & Equipment imports (USD 451.5 Mn), and Textiles and textile articles (USD 105 Bn). Total remittances also declined by 35.4% (Y/Y) for the month resulting in worsening of current account balance.

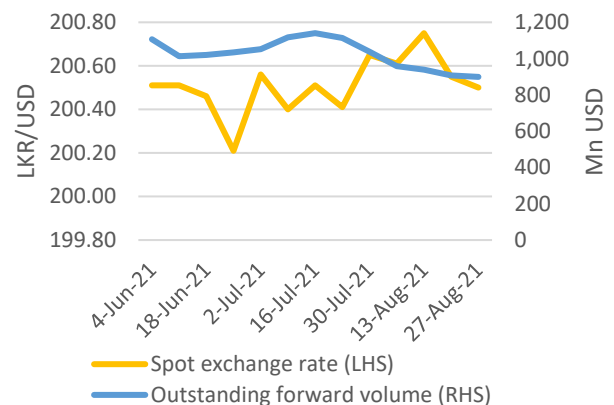
Figure 5: Gross official reserves (Mn USD)



Source: CBSL

Sri Lanka received its SDR allocation equivalent to USD 787 Mn and a sum of USD 150 Mn under the swap arrangement with the Bangladesh Bank in August. The CBSL managed to collect around USD 57.4 Mn through an SLDB auction held during the month. In the meanwhile, forex intervention by the CBSL resulted in USD 176 Mn drain on reserves. In this setting, the overall reserve position strengthened to USD 3.5 Bn from USD 2.8 Bn in the previous month.

Figure 6: Interbank spot market



Source: CBSL

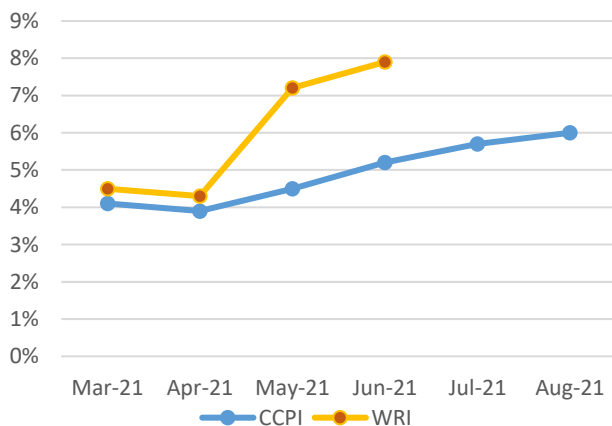
Activity level in the interbank spot market remained subdued throughout August. The CBSL has pegged the rupee using moral suasion and caused

the black market – which charges a hefty premium over the official rate – to thrive. Nevertheless, under extreme pressure on the Net Open Positions, rupee breached the 203 mark twice during the month. To ease the pressure, the CBSL released over USD 200 Mn to state commercial banks by the month end. Importers often find it difficult to open LCs to import various items. As a result, the consumers are faced with shortages in essential goods which are price controlled by the regulator. In addition, in order to indirectly coerce exporters to convert export proceeds, the CBSL imposed a 5% interest rate ceiling on foreign currency deposits.

Forward premium increased marginally compared to July numbers, but overall activity levels declined causing forward volumes to decline further.

## Prices & Wages

Figure 7: CCPI and Nominal Wage Rate Index of the informal private sector (Y/Y)



Notes: WRI (100=2012), CCPI (100=2013)

Sources: CBSL, CSD

Wage growth jumped to 8% in June from its lower base that prevailed around the same time last year due to continued recovery of industry and services sectors.

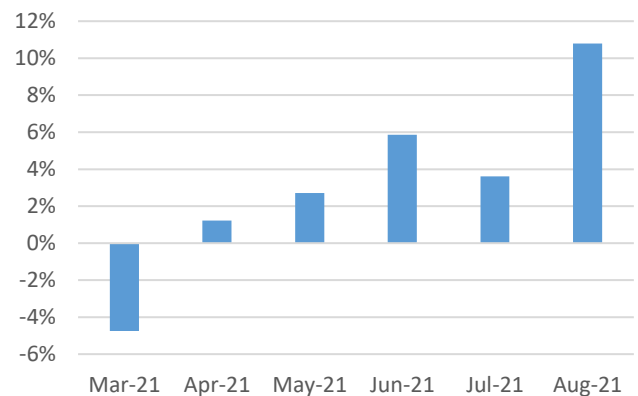
Overall headline Inflation increased to 6% driven mainly by a surge in non-food inflation. Increase in non-food inflation is broad-based with notable rise in prices of Transport, Restaurants & Hotels, and Health subgroups. Acute shortage in LP gas led to price increase. Furthermore, the National Medical Regulatory Authority has hiked controlled drug prices by about 9% towards the end of the month.

As the food crisis worsened, the cabinet abolished the import tax of 175 rupees per kg of milk powder in an attempt to bring down the price. In addition, cabinet nod was received to import rice to curb rice prices. GoSL declared a food emergency at the end of August amid double-digit food inflation.

## Equities

### Domestic Market

Figure 8: ASPI (M/M)



Source: CSE

The stock market experienced a sharp uptick during August as the market closed with ASPI and S&P SL20 gaining over 10.8% and 10% respectively as investors turned bullish over speculation that GoSL was seeking support from the IMF for debt restructuring. Foreigners however remained net sellers. Overall Market PBV (Price-to-Book-Value) increased from 1.15 to 1.26 favoring sellers.

### Global Markets

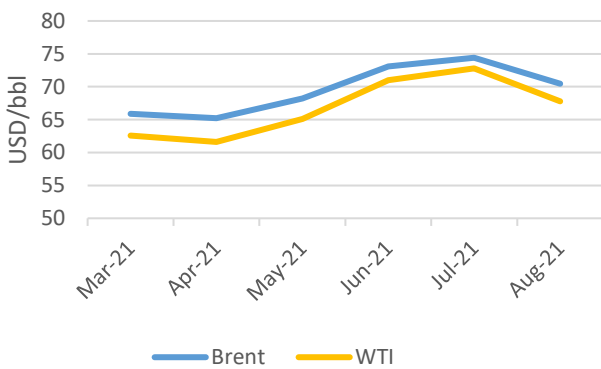
The US equities remained upbeat as the Dow Jones and S&P500 posted impressive performance following an improving labor market, strong corporate earnings and clarity from the Fed on scaling back its bond purchasing programme. Nevertheless, pending fears regarding the spread of the Delta-variant led to brief pullbacks in stock prices. European markets mostly recorded gains with Germany, UK and France being top performers. Despite rising case numbers in many Asian countries, markets displayed mixed sentiment with India and Japan recording gains while China and Hong Kong recording losses.

Figure 9: GICS sector performance- July

Sector	Index Points Gained
Transportation	16787
Consumer Durables & Apparel	474
Diversified Financials	431
Household & Personal Products	232
Commercial & Professional Services	108
Capital Goods	40
Health Care Equipment & Services	35
Food, Beverage & Tobacco	34
Banks	11
Real Estate	2
Energy	2
Consumer Services	-13
Utilities	-24
Telecommunication Services	-51
Food & Staples Retailing	-52
Insurance	-75
Retailing	-88
Materials	-107
Automobiles & Components	-156

## Commodities

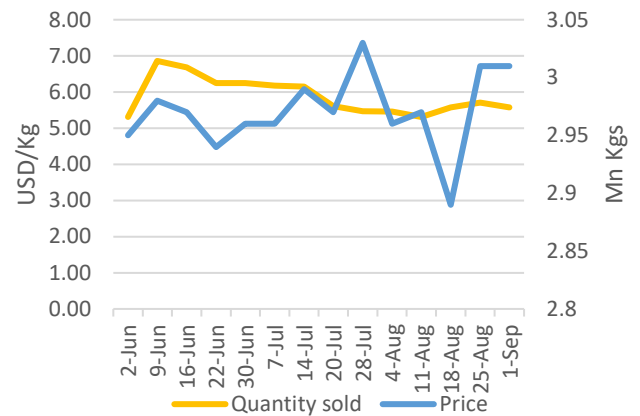
Figure 10: Crude oil price



Source: Bloomberg quoted in CBSL

Global oil prices which have been rising continuously, experienced a decline in August. The spike in Delta-variant around the world resulted in a dip in demand for crude oil. The OPEC+ countries had previously agreed to increase production from July onwards in the hope of continued global economic expansion. However, oil producers are awaiting clarity on how the spike in Delta-variant is going to impact the global economy.

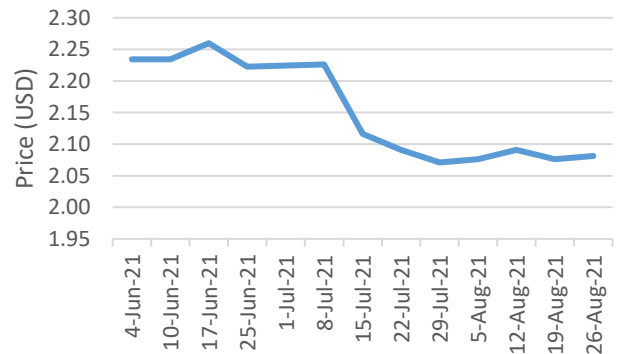
Figure 11: Tea (All Elevations) price and quantity sold at weekly auctions



Source: Forbes & Walker

Tea prices in the Colombo auction slid during the first half of the month. However, prices recovered towards the end of the month supported by favourable weather conditions.

Figure 12: Rubber price weekly auctions

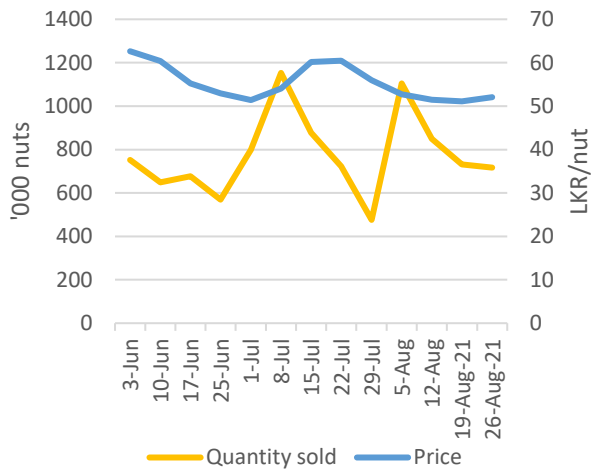


Note: Price of Latex 4X

Source: RRISL

Rubber prices at the Colombo auctions remained at lower levels following a sharp decline in the previous month. Global rubber prices also remained at low levels as a result of rising COVID cases in India and China which are the largest consumers.

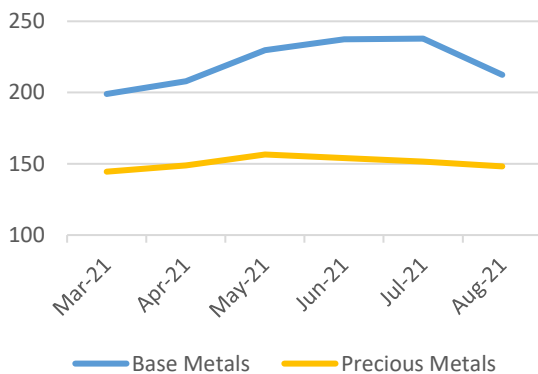
Figure 13: Coconut price weekly auctions



Source: CDA

Coconut prices declined once again in August likely as a result of poor quality. Supply also dwindled over the course of the month.

Figure 14: Metal price index (2016=100)



Notes: Base metals index includes Aluminum, Cobalt, Copper, Iron Ore, Molybdenum, Nickel, Tin, Uranium, and Zinc, precious metals index includes Gold, Silver, Palladium, and Platinum  
Source: IMF

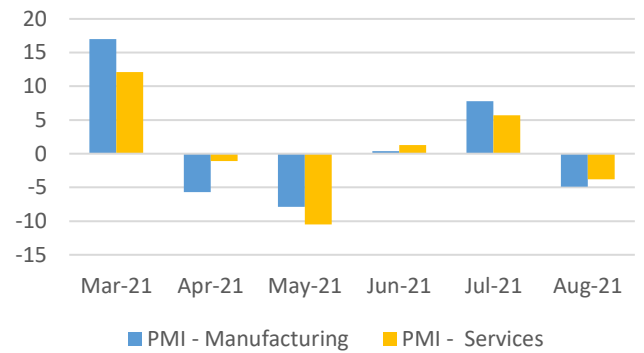
At the start of August Gold slumped to four-month low as strong US job data bolstered expectations of economic growth. However, lower-than-expected job numbers resulted in gold prices retreating towards the end of the month.

Base metal prices slid as copper prices slumped to its lowest in nearly two months resulting from weaker global demand. Global iron ore declined, as data points on slowing economic activity and steel production cutbacks emerged out of China [2]. Prices of other metals such as aluminum, nickel,

lead and zinc also experienced a decline as demand from China faltered.

Read ICRA Lanka's report on the [implications of rising commodity prices for Sri Lanka](#).

Figure 15: PMI deviation from point of neutrality (Index points)



Notes- negative values indicate sector is generally contracting on a month-on-month basis while positive values indicate the sector is expanding. The strength of contraction or expansion is manifested by the magnitude of the figure. Source: CBSL

PMI for Manufacturing and Services deteriorated in August compared to July due to the lockdown. Continuous increases in raw material costs as a result of rupee depreciation adversely affected profit margins of manufacturing companies. Additionally, the travel restrictions caused considerable decline in business activity for service sector companies.

## Outlook for September-October

As of 13<sup>th</sup> September, nearly 49% of the population is fully vaccinated while nearly 62% have received at least one dose. Sri Lanka imposed a fresh set of lockdown measures on 20<sup>th</sup> August and from early September infection rates seemed to be improving slowly. Since current lockdowns are less restrictive than in previous instances, the disruptions to economic activity are expected to be lower.

The policy rate hike in August came as a surprise to many market actors. Current, hawkish stance by the CBSL is quite a reversal of its loose monetary policy cycle that prevailed over a year previously. As an inevitable consequence of this, and rising

inflation rate, we may see the entire term structure further adjusting upwards. We doubt whether we have seen the end of the current monetary tightening. Therefore, more rate hikes may still be on the cards.

Financial sector may face higher funding costs moving forward, altering the balance sheet composition in the next few months. This, in combination with gloomy outlook, points to a slowdown in credit to the private sector. However, given the government's financing needs, state banks may continue to expand their asset base at a moderate pace.

ICRA Lanka maintains that restrictions imposed on the current account and capital account are likely to blowback rather than improve the balance of payment situation. Swaps and foreign currency loans would provide only temporary relief but will not be sufficient to generate a lasting improvement in the external sector. Many domestic industries are struggling to meet the demand due to shortages in inputs triggered by scarcity of forex and import controls. In addition, foreign trading partners may push back as seen from a statement made by the European Union (EU) Mission in Sri Lanka early August. In addition, the CBSL imposed a 100% cash margin deposit requirement against the importation of selected goods which will tighten the liquidity position of the importers. This will further dent economic activity and bring about scarcity in the targeted goods. The import controls and capital controls may be effective tools in managing short-term volatilities in the exchange rate but it comes at the expense of economic growth, external sector competitiveness, and cost of living for people.

Current inflation trajectory may breach the CBSL's inflation target in the medium term. At the global front, prices have retreated but historically domestic prices are relatively downward inelastic. Therefore, it may take a month or two to calm domestic inflation.

Read ICRA Lanka's [Midyear Economic Update](#).

## Rating Actions

Following rating actions were taken by ICRA Lanka during the month of **August**.  
Visit <https://www.icralanka.com/ratings/> to read the rating rationales.

Issuer	Issue	Action	Previous Rating	Current Rating
People's Merchant Finance PLC	Issuer Rating	Revised	[SL]B (On Watch)	[SL]B (Stable)
Asia Asset Finance PLC	Proposed Asset backed secured debenture program (LKR 1000 Mn)	Assigned	N/A	[SL]A-(SO) (Stable)
Vallibel Finance PLC	Issuer Rating	Revised	[SL]BBB (Stable)	[SL]BBB+ (Stable)
Softlogic Stock Brokers	Issuer Rating	Assigned	N/A	[SL]BBB (Stable)
Union Bank	Issuer Rating	Reaffirmed	[SL]BBB (Stable)	[SL]BBB (Stable)
E B Creasey & Company PLC	Issuer Rating	Assigned	N/A	[SL]BBB (Stable)

## Abbreviations

ASPI	All Share Price Index
bps	Basis points
pps	Percentage points
CBSL	Central Bank of Sri Lanka
CDA	Coconut Development Authority
CSD	Census and Statistics Department
CSE	Colombo Stock Exchange
GICS	Global Industry Classification Standard
GoSL	Government of Sri Lanka
SLDB	Sri Lanka Development Bonds
SLISB	Sri Lanka International Sovereign Bonds
SOFR	Secured Overnight Financing Rate
PMI	Purchasing Managers Index
RRISL	Rubber Research Institute of Sri Lanka
YTD	Year-to-date

## References

- [1] CBSL, "Monetary Policy Review: No. 06," CBSL, Colombo, August 2021.  
[2] J. Roy, P. Ruparelia, R. Ghosh and D. Ghosh, "Indian Iron and Steel Sector Monthly Update," ICRA, August.

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Published date: September 16, 2021  
Document #: meusep21

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